Contract Assets (ASC 606)

🔹 **Definition**

A **contract asset** is a company's **conditional right to receive consideration** for goods or services already transferred to a customer. It arises when:

- The company has **partially satisfied** performance obligations.
- The right to payment is **not yet unconditional** (i.e., invoicing depends on further performance).

🔑 Key distinction: A contract asset becomes an **accounts receivable** once the right to payment is **unconditional**.

🔍 **Recognition Criteria**

- Revenue is recognized for the **satisfied portion** of the contract.
- The company **cannot invoice** until additional obligations are fulfilled.
- The asset is reported on the **balance sheet** under current assets.

🖩 **Journal Entries**

Step 1: Partial performance (contract asset created)

plaintext

Dr Contract Asset ..... [Value of obligation A]

Cr Sales Revenue ..... [Value of obligation A]

Step 2: Full performance (contract asset converted to receivable)

plaintext

Dr Accounts Receivable ..... [Total contract value]

Cr Contract Asset ..... [Value of obligation A]

Cr Sales Revenue ..... [Value of obligation B]

📊 **Example: Software Implementation Contract**

Scenario:

- Total contract: $100,000
- Deliverables:
  - Software license (Obligation A): $60,000
  - Implementation services (Obligation B): $40,000
- Invoice only after both are completed.

March 1: Software delivered

plaintext

Dr Contract Asset $60,000

Cr Sales Revenue $60,000

April 15: Implementation completed, invoice issued

plaintext

Dr Accounts Receivable $100,000

Cr Contract Asset $60,000

Cr Sales Revenue $40,000

Five-Step Revenue Recognition Model (ASC 606)

🔹 **Overview**

ASC 606 introduces a **principles-based, five-step model** for recognizing revenue from contracts with customers. It applies to **all industries** and **all types of revenue transactions**, except for those explicitly scoped out (e.g., leases, insurance, financial instruments).

✅ **The Five Steps**

Step	Description
1. Identify the Contract	Ensure the agreement creates **enforceable rights and obligations** and meets all criteria under ASC 606.
2. Identify Performance Obligations	Break the contract into **distinct goods/services** that the customer can benefit from independently.
3. Determine the Transaction Price	Estimate the **amount of consideration** the company expects to receive, including variable amounts.
4. Allocate the Transaction Price	Assign the transaction price to each performance obligation based on **relative standalone selling prices**.
5. Recognize Revenue	Record revenue **when or as** each performance obligation is satisfied—either **over time** or **at a point in time**.

🔍 **Step 1: Identify the Contract**

A contract must:

- Be **approved** by both parties (written, oral, or customary practice).
- Clearly define **rights and payment terms**.
- Have **commercial substance** (affects cash flows).
- Be **probable of collection**, considering customer credit risk.

📌 **Not in scope**: Leases (ASC 842), insurance contracts, financial instruments, nonmonetary exchanges.

🧠 **Examples of Valid Contracts**

Scenario	Type of Satisfaction
Retail purchase at cashier	**Point in time**
Online order with credit card	**Point in time**
Construction contract with progress billing	**Over time**
Annual service contract with monthly visits	**Over time**

📊 **Revenue Recognition Timing**

Satisfaction Type	Recognition Trigger
Point in Time	When control transfers (e.g., delivery, handover)
Over Time	As control transfers progressively (e.g., construction, services)

🧾 **Journal Entry Example (Point in Time)**

Customer receives product, payment pending:

plaintext

Dr Accounts Receivable ..... [Amount]

Cr Sales Revenue ..... [Amount]

If cash is received in advance:

plaintext

Dr Cash ..... [Amount]

Cr Contract Liability ..... [Amount]

When performance obligation is satisfied:

plaintext

Dr Contract Liability ..... [Amount]

Cr Sales Revenue ..... [Amount]

🧠 **CMA Exam Strategy Tips**

- Focus on **performance obligation satisfaction**, not cash flow.
- Know the difference between **contract asset**, **contract liability**, and **receivable**.
- Understand **variable consideration**, **standalone selling price**, and **allocation methods**.

Step 2: Identify the Separate Performance Obligations

🔹 **Definition**

A **performance obligation** is a **promise** in a contract to transfer a **distinct good or service** to the customer. A contract may contain:

- **One** performance obligation (e.g., sale of a single product)
- Or **multiple** separate and distinct obligations (e.g., bundled products/services)

🧩 **Two-Part Identification Process**

1️⃣ **Identify Promises in the Contract**

- Includes **explicit** promises (written/oral)
- Also includes **implicit** promises based on:
  - Customary business practices
  - Marketing materials
  - Published policies
  - Oral representations

📌 **Examples of implicit promises**:

- Free maintenance with a car purchase
- Loyalty points
- Free upgrades or accessories

2️⃣ **Determine Which Promises Are Distinct**

A good or service is **distinct** if:

- **(a)** The customer can benefit from it **on its own** or with other readily available resources
- **(b)** The promise to transfer it is **separately identifiable** from other promises in the contract

📌 **Not distinct**: Tasks like account setup, activation, or enrollment—they don't transfer a good/service.

🧠 **Examples of Performance Obligations**

Scenario	Performance Obligations
Retail sale of 3 items	Each item is a separate obligation
Software + implementation + support	Each is distinct if separable and beneficial
Free maintenance with car purchase	Free maintenance is a separate obligation
Loyalty points	Separate obligation if they provide future discounts

Scenario	Performance Obligations
Membership activation	**Not** a performance obligation (administrative task)

📊 **Journal Entry Snapshot (When Revenue Is Recognized)**

plaintext

Dr Accounts Receivable ..... [Total contract price]

Cr Sales Revenue ..... [Allocated to each obligation]

Revenue is recognized **as each obligation is satisfied**, either **over time** or **at a point in time**.

🧠 **CMA Exam Tips**

- Look for **distinct goods/services**—not just line items.
- Watch for **implicit promises**—they count if they create customer expectations.
- Use the **two-part test**: Can the customer benefit independently? Is the promise separately identifiable?

📘 **Step 3: Determine the Transaction Price (ASC 606)**

🔹 **Definition**

The **transaction price** is the amount of consideration the company **expects to be entitled to** in exchange for transferring promised goods or services to the customer. It may differ from the **contractual price** due to:

- Variable consideration
- Significant financing components
- Non-cash consideration
- Consideration payable to the customer
- Exclusion of taxes collected on behalf of third parties

🧩 **Key Adjustments to Transaction Price**

1️⃣ **Variable Consideration**

Occurs when payment depends on future events (e.g., bonuses, penalties, discounts, returns).

- **Estimation Methods**:
  - **Expected Value**: Probability-weighted average of possible outcomes.
  - **Most Likely Amount**: Single most probable amount.

🔐 **Constraint**: Include variable consideration **only if it's probable** that a **significant revenue reversal will not occur** when uncertainty resolves.

📌 **Example**: A company may expect a $100,000 bonus if it completes a project early. If it estimates a 70% chance of earning it:

- Expected value = $100,000 × 70% = $70,000

2️⃣ **Significant Financing Component**

If payment is deferred **>1 year**, the transaction price must reflect the **time value of money**.

- **Revenue** = Present value of consideration
- **Interest income** = Recognized separately over time

📌 **Example**: A customer agrees to pay $120,000 in two years. If the appropriate discount rate is 5%, the present value (revenue recognized) is:

- PV = $120,000 ÷ (1.05)^2 ≈ $108,843
- Interest income = $11,157 over two years

3️⃣ **Taxes Collected on Behalf of Others**

Sales tax and similar amounts are **excluded** from the transaction price if the company elects this treatment and discloses it per ASC 235.

📌 **Example**: If a product sells for $1,000 + $100 sales tax, the transaction price is **$1,000**, not $1,100.

🧾 **Journal Entry Example (Financing Component)**

At sale (with deferred payment):

plaintext

Dr Contract Asset / Receivable $108,843

Cr Sales Revenue $108,843

Over time (interest income):

plaintext

Dr Receivable / Cash $11,157

Cr Interest Income $11,157

🧠 **CMA Exam Tips**

- **Focus on estimation methods** for variable consideration.
- **Time value of money** is key for financing components—know how to calculate present value.
- **Revenue ≠ cash received**—it's based on expected entitlement.
- **Update estimates** each reporting period for changes in facts or circumstances.

📘 **Step 4: Allocate the Transaction Price (ASC 606)**

🔹 **Objective**

When a contract includes **multiple performance obligations**, the total transaction price must be **allocated** to each obligation based on its **relative standalone selling price**.

🧩 **Allocation Process**

1. **Determine Standalone Selling Prices (SSP)**
    - Use observable prices when available (e.g., catalog price, market rate).
    - If not directly observable, estimate using:
        - Adjusted market assessment
        - Expected cost plus margin
        - Residual approach (only in limited cases)
2. **Apply Proportional Allocation**
    - Allocate the total transaction price **proportionally** to each performance obligation using the formula:

$$\text{Allocated Price} = \text{Total Transaction Price} \times \left(\frac{\text{SSP of Obligation}}{\text{Total SSP of All Obligations}} \right)$$

3. **Bundle Discounts**
    - If a bundle discount exists, it must be **spread proportionally** across all obligations based on their SSPs.
4. **Contract Modifications**
    - If the contract price changes during performance, **reallocate** using the **original allocation basis**, even if SSPs have changed.

🎁 **Example: Software Bundle Allocation**

Contract Price: $180,000 **Standalone Selling Prices**:

- Software License: $120,000
- Implementation Services: $40,000
- Technical Support: $60,000 **Total SSP** = $220,000

Allocation:

- Software: $180,000 × (120,000 ÷ 220,000) = **$98,182**
- Implementation: $180,000 × (40,000 ÷ 220,000) = **$32,727**
- Support: $180,000 × (60,000 ÷ 220,000) = **$49,091**

🚚 **Shipping & Handling Considerations**

Shipping Term	Revenue Recognition	Policy Election Needed
FOB Shipping Point	At shipment	✅ Yes — may elect to treat shipping as fulfillment
FOB Destination	At delivery	❌ No — always treated as fulfillment

📌 Shipping performed **after control transfers** can be treated as a **fulfillment activity** if the company elects that policy. No separate performance obligation is needed.

🧠 **CMA Exam Tips**

- Always **allocate discounts proportionally**.
- Know how to **calculate allocations** using SSP ratios.
- Understand **contract modifications** must follow original allocation logic.
- Be clear on **shipping terms** and their impact on revenue timing.